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Treasury Shares on the Balance-sheet

By H. G. Bowles

Wide divergence of opinion as to the nature of treasury stock is made evident by the variation in treatment accorded these shares in published balance-sheets and by recently published comments of those interested in the legal, theoretical accounting and practical accounting aspects of treasury stock. Perhaps the hard-headed practitioner should not be quick to take offence at demagogic, arbitrary resolving of highly involved and intricate problems of theory and practice of accountancy by those not fully conversant with his professional point of view but should extract for consideration such stimulating suggestions as may have been produced and relegate the rest to a fitting repository.

This article is intended to present a brief but comprehensive outline of the theory and practice of accountancy with respect to the balance-sheet presentation of treasury stock, from the point of view of the practitioner who has struggled and strained with the problems involved in hand-to-hand encounter.

Treasury shares represent stock once issued, subsequently acquired but not retired by the issuing corporation. They have been variously classified on recently published financial statements of representative corporations (including many audited by reputable public accountants) as current assets, investment assets, unclassified assets, as deductions from earned surplus, from stated capital, from aggregate net worth and from various combinations of individual elements of net worth. Valuation assigned to treasury shares, where indicated in these balance-sheets, may be cost of acquisition, original issued price, par or stated value, market value (with liquidation value mentioned occasionally) or an assigned value based upon a fractional portion of a capital-stock value (which may or may not have undergone major revaluation or recapitalization adjustments subsequent to its initial determination).

The indisputable fact that treasury shares have not been uniformly classified and valued by public accountants in financial statements prepared by them is not, in itself, a valid criticism of any particular treatment accorded to treasury shares. Neither may it fairly be said that condemnation is necessarily due ac-

countants in those not infrequent cases in which jurisdictional statutes, as modified and interpreted by court decisions, apparently (to some one) conflict with the classification or valuation adopted.

The public accountant contracts with his client to perform certain services, among which the preparation of financial statements is usually included. He is expected to exercise the full measure of his professional skill and native ingenuity in presenting the true financial position and history of his client, subject to necessary qualifications, as he conceives that true position and history. In performing his duty of assembling, classifying, arranging and describing the various items composing a corporation balance-sheet the practitioner is not acting primarily as a governmental agent nor as an interpreter of relevant statutes in effect as modified by a maze of conflicting court decisions. He is interested in these considerations only to the extent that they will aid him in formulating an opinion as to what is in fact the true financial position of the corporation. He is not inclined to give serious weight to statutory restrictions and directions even if relevant to his client's financial position unless and then only to the extent that the influence of these considerations constitutes a material factor.

A corporation attorney is concerned with the legal significance of a corporation's financial structure and transactions. A public accountant is not restricted to legal concepts of his client's financial affairs but is free to utilize or create, on occasion, accounting concepts which may be entirely new or different from any established in statutes or by courts. His only checkrein is an abstract ideal, true financial condition, as he sees it. The development of theories and practices in accountancy usually precedes but may follow legal interpretations of them.

If it were desired to judge the propriety of the classification and valuation assigned to treasury shares appearing in a corporation's balance-sheet at a particular date it would be necessary not only to inquire into jurisdictional statutes as interpreted by court decisions, provisions contained in the corporate charter and by-laws, the evident or implied intent underlying the acquisition of treasury shares, the financial position of the corporation before considering treasury shares and special considerations of various kinds as to their relationship toward the corporation's balance-sheet, but also to weigh properly the

relative significance of the various factors, to exclude technicalities not material, to arrange material factors so as best to present, in the judgment of the practitioner as an expert, the true financial position of the corporation.

In an article appearing in a recent issue of THE JOURNAL OF ACCOUNTANCY we were reminded that "there is no legal authority applicable to the ordinary purchase or acquisition of shares which supports a differentiation of treatment based on intent or purpose." As if, indeed, public accountants are restrained by the absence of legal authority in performing their duty of judging the proper significance, in relation to financial position, of either evidenced or implied intent, frequently considerations of major importance in classification procedure.

Theories upon which accountancy relies, theories which have contributed to its orderly development, are constantly undergoing the revision and modernization from which the passage of time and changing social, economic and political conditions exempt no general principles.

A critical consideration of accountancy practice with regard to balance-sheet presentation of treasury shares reveals underlying theories as to their essential nature. The more important of these theories are briefly reviewed in the following paragraphs. Before entering into this review let us dispose of the question of treatment of treasury shares, so-called, arising from the acquisition by a corporation of its own shares of ownership pursuant to statutory authority for redemption, in compromising in good faith a debt otherwise uncollectible, in eliminating fractional shares and in other ways directly reducing stated capital. It is clear that technical failure formally to retire such shares does not justify their treatment as true treasury shares and that the procedure involved in eliminating them from the balance-sheet by appropriate reduction of capital-stock values does not constitute a material misrepresentation. The term "treasury shares" as used herein does not include items of this nature, and for expediency will imply, where appropriate, "treasury shares value."

It has been maintained that treasury shares are deductible (separately) on balance-sheets from the capital values assigned to the class of shares within which they are included. This contention is supported by the fact that a purchase of treasury shares is a virtual if not legal retirement of capital contribution.

The transaction is effected by distributing corporate assets and reducing the number of undivided interests in the corporate net worth as made evident by outstanding shares of ownership.

This theory, which I may call the offset theory, is alleged to be misleading and improper on the ground that by separately deducting treasury shares from contributed capital values the impression is created that a legal concept, "stated capital," has been reduced. In jurisdictions definitely establishing this legal concept, stated capital may ordinarily be reduced only after duly instituted legal proceedings, and in those jurisdictions (relatively few) which have adopted modern statutes dealing with stated capital and treasury shares, the acquisition of such shares is permissible only to the extent that surplus (usually earned surplus) is available. It is further contended that the existence of a surplus available for such acquisition without impairment of stated capital does not justify the adoption of the offset theory of balance-sheet presentation of treasury shares—this because the amount of surplus is said to be misrepresented unless actually reduced by the treasury shares and, conversely, stated capital is represented to have been reduced without factual support.

Values assigned to treasury shares classified under the offset theory are, variously, acquisition cost, par or stated value or an assigned value calculated on any one of numerous alternate bases. Usually par or stated value governs.

Practice has endorsed the offset theory. The prudent practitioner adopting this theory will, however, carefully consider the materiality (with reference to financial condition) of jurisdictional statutes and will not fail to mention, in case of questionable materiality, the changes in his statements, either in classification or valuation, necessary to reflect alternate points of view.

A large group of practitioners maintains that treasury shares acquired in certain circumstances constitute a corporate asset. To support this theory we are reminded that a corporate board of directors is required to act for the general welfare of the corporation and, in order safely to employ surplus cash funds, to take advantage of temporarily depressed market values, to reduce dividend requirements, to engender goodwill by stabilizing market values, to consolidate voting control or for other reasons might well cause the corporation to purchase or otherwise acquire treasury shares with the intent of subsequently disposing of them for a consideration.

In many jurisdictions the legal right to purchase treasury shares is dependent upon the existence of surplus available for this purpose and paid-in capital values are not thereby reduced.

Where statutory restrictions are deemed to be material factors in these cases, one would expect to see an appropriation of earned or other (available for the purpose) surplus to some such classification as "surplus appropriated to purchase treasury stock" which upon sale of treasury shares might become "paid-in surplus arising from sale of treasury shares." The failure to show such an appropriation, however, is not in itself a fair subject of adverse criticism of the accountant preparing the balance-sheet, who can discharge his duty of full disclosure of a material fact by mentioning in a suitable place that the corporate board of directors has failed to authorize this appropriation and that surplus available for dividends as earnings (or other surplus, as the case may be) is subject to reduction by the amount of the value (ordinarily cost) of treasury shares acquired.

It has been contended that treasury shares are restored to the status of authorized but unissued shares and that no better justification exists for considering them an asset than for so considering all authorized but unissued shares. This contention can not be supported under the conditions outlined in the above paragraphs. Treasury shares are still issued, in the sense that stated capital arising from their issuance remains intact. They are available, in the absence of statutory or stock-exchange prohibition, for immediate resale at market prices and are therefore exchangeable for cash. Authorized but unissued stock is also ordinarily exchangeable for cash when permits are readily obtainable and a security market is available, but stated capital arises from this transaction and an issue of such stock is a representation that the proceeds will be preserved as a capital fund for the reliance of shareholders and creditors. These representations do not generally apply to the sale of treasury shares, which frequently may be realized at most advantageous offer without regard to par or stated value, without changing stated capital, without the purchaser's incurring liability for the difference, if any, between purchase price and par or stated value.

While admitting the absence of liquidating value (assets other than treasury shares may have no liquidating value) the advocates of the asset theory feel that to a going concern, the presenta-

tion of treasury shares as an asset in certain circumstances, at some suitable valuation basis, usually cost or market, properly reflects the true financial position of the corporation with respect to these shares.

An oft quoted court decision reads in part as follows:

> To carry the shares as a liability and as an asset at cost is certainly a fiction, however admirable. They are not a liability and on dissolution could not be so treated because the obligor and obligee are one. They are not a present asset because, as they stand, the defendant can not collect upon them. What, in fact, they are is an opportunity to acquire new assets for the corporate treasury by creating new obligations . . .

This denial of the propriety of considering treasury shares an asset is probably representative of the view of those opposing the asset theory. There are, however, court decisions affirming that treasury stock is an asset, is even personal property.

Historically, the asset theory is perhaps one of the first generally accepted principles for the classification and valuation of treasury shares in balance-sheets. While a distinct trend has been recently observable toward the discarding of this theory in favor of others, its supporters still comprise a large group within the ranks of public accountants. It might be ill advised to assert that the observed trend will eventually result in the elimination of this theory as a serious factor. Trends have been known to reverse themselves, as witness the late lamented consolidation and merger trend.

A third theory regarding the balance-sheet presentation of treasury shares, which I may call the surplus deduction theory, is one that seems most in recent favor to supplant other theories and involves the deduction of treasury shares from earned or other surplus available for this purpose.

Probably enlightened legislation in recent years, adequately defining the term "stated capital" and recognizing in clear language certain accounting concepts, has been the inspiration for the development of this theory. Accountants have perhaps been influenced, in reaching a conclusion respecting the materiality (from the viewpoint of true financial position) of statutes and court decisions, by the contradictory, vague and elusive nature of such statutes and court decisions, especially with regard to legal definition of accountancy's terms and tools. Where, then, statutes are adopted embodying progressive and modern inter-

pretations, the accountant is ready and eager to give due weight to them in preparing financial statements.

The practice of showing treasury shares as a surplus deduction involves a recognition, then, of statutory requirements and the legal concept that a portion of capital is stated capital as being material factors in the preparation of a balance-sheet. Where this theory is adopted, the classification and valuation of treasury shares will ordinarily follow statutory provisions, subject to the opinion of the accountant. Practice seems to favor deduction from earned surplus and a valuation at cost of acquisition. If any other valuation basis is used, the gain or loss ordinarily passes to some form of surplus not available for dividends as earnings.

No important opposition has arisen against the surplus-deduction theory other than that to be expected from proponents of the asset or offset theories. Where practitioners have changed the form of their balance-sheet presentation of treasury shares recently, the surplus-deduction theory appears to be the survivor in many instances, indicating a trend toward the adoption of this theory.

Occasionally we find treasury shares deducted from the aggregate of other elements of net worth or from various combinations of individual elements of net worth. This treatment may be accorded treasury shares under either the offset or surplus-deduction theory in those corporations whose capital structure is complex and has undergone a series of important changes over a period of years. Frequently records available do not disclose the complete financial history of a corporate capital structure. More frequently the cost of preparing a trustworthy analysis would be prohibitive. Being unable to satisfy himself fully as to the accuracy of the recorded classification and relative amounts of elements of the corporate net worth, the accountant has no choice but to apply the treasury-share deduction against net worth in total or against those particular elements which might reasonably be supposed to include the factors which if separately established could be used for treasury-share deduction.

Another possible explanation of the deduction of treasury shares from aggregate net worth would be the application of what I may call pure accountancy theory to the acquisition of treasury shares. Pure theory would describe the transaction as a distribution of contributed capital together with gains or losses accrued thereto in retirement or reduction of net worth. To

apportion the reduction value of treasury shares equitably against each of the elements of net worth would seem witless; therefore deduction is made from total net worth. This same pure theory, however, does not recognize the "stated capital" concept and would consider inequitable any reduction in the elements of net worth not consistent with the fractional reduction in total net worth arising from the acquisition of treasury shares. The use of pure theory in balance-sheet presentation of treasury shares might be criticized as being inconsistent with the balance-sheet presentation of assets and liabilities such as deferred bond discount, organization expense and unearned income, items whose usual treatment conflicts with pure theory, which frequently is at swords' points with the sort of working theory that underlies practice.

Inevitably practice will gravitate toward theory and theory will be modified and expanded to a point reconcilable with practice. Who can forecast the meeting point? The resolving of this conflict will absorb the attention of public accountants in the near future. Recent years have witnessed the trend toward the acquisition by corporations of large blocks of their own share issues with attendant problems of balance-sheet presentation. Future years will bring their own problems as these holdings are disposed of, retired or classified in new and even more ingenious ways.

If some reader is interested in trends and their ultimate outcome he has perhaps speculated on the treasury-stock purchase trend by large corporations, particularly those having surplus accumulated, available for treasury-stock purchases in excess of the market value of all outstanding shares. Imagine the embarrassment of a board of directors, which has authorized unlimited purchases at favorable prices, upon discovering that by coincidence the corporation has acquired its entire stock issue. In whom would ownership of the remaining corporate net assets reside?